The Macro Research Desk

Herman van Papendorp
(Head of Investment Research and Asset Allocation)

Sanisha Packirisamy
(Economist)

SA Budget FY2017/18: Gordhan guarding government's gates

SA remains on a prudent fiscal management path

Amidst a low-growth environment, Finance Minister Pravin Gordhan kept SA on a prudent fiscal management path by pulling a number of tax levers. With the tax burden (tax-to-GDP (gross domestic product) ratio) continuing to rise and projected revenue growth outstripping expenditure growth during the medium-term expenditure framework (MTEF), Momentum Investments does not view the budget as being growth-friendly. However, government aims to grow non-interest expenditure at an average real rate of 2.0% per year during the MTEF in an effort to partly offset the effect of a contractionary budget. In the company's opinion, the budget was tilted towards government interventionist approaches, rather than providing increased support to SA's business sector. Without improved clarity about SA's operating environment, fixed investment and private sector job creation will likely remain constrained.

Budget negative for equities, but marginally positive for the bond market

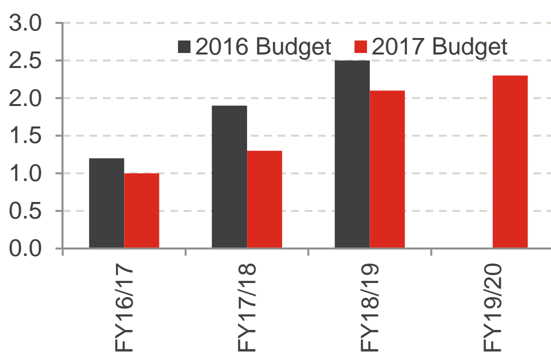
In Momentum Investments' opinion, the high-level contractionary nature of the budget is slightly negative for equities, while the continued commitment to fiscal consolidation, at the margin, benefits the bond market. The FTSE/JSE All-Share Index remained 1% in the red after the budget speech, dragged lower by the FTSE/JSE Resources Index (negative 2.5%). The FTSE/JSE Industrials Index fell further to negative 1.1%, partly owing to a fall in consumer-related stocks. The FTSE/JSE Financials Index rose from a negative 0.9% reading, before the speech, to negative 0.5%, following the announcement. Meanwhile, in the fixed income market, the yield on the R186 government bond tracked sideways, following the budget speech. The effect on the currency was relatively limited initially, with the rand weakening marginally against the major global currencies, but strengthening more meaningfully after market close.

Marginal downside risk to Treasury's nominal growth forecasts

Despite a modest expected improvement, the domestic growth outlook remains challenging. Though commodity prices have risen around 20% in recent months, rising interest rates in the United States (US) and protectionist threats from the new US administration could have an adverse effect on global trade activity, particularly for emerging markets. Moreover, a more meaningful improvement in trend growth requires the implementation of structural reforms to enable a recovery in business and consumer confidence.

Relative to the October 2016 Medium Term Budget Policy Statement (MTBPS), Treasury maintained its average real GDP growth estimate for the next three fiscal years at 1.9% per year. Nonetheless, Treasury's growth forecasts are markedly lower than where they were pitched at the time of the February 2016 national budget (see chart 1). These projections are broadly in line with Momentum Investments' internal GDP growth estimates, which incorporate a mild economic growth recovery in line with an expected higher degree of economic policy certainty, following the ruling party's National Elective Conference in December 2017.

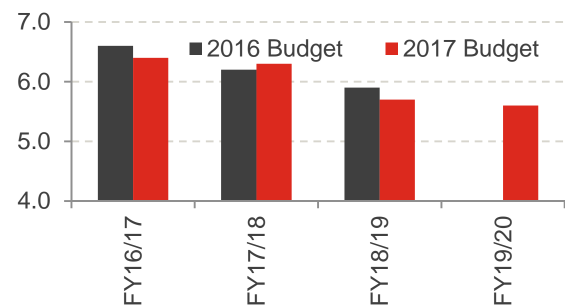
Chart 1: Treasury lowers real GDP growth forecasts (%)



Source: National Treasury, Momentum Investments

Treasury expects headline inflation to average 5.9% between FY2017/18 and FY2019/20 (see chart 2), nearly 0.5% higher than Momentum Investments' internal estimates. While a firmer currency and an expected drop in food inflation should lead inflation lower in the next year and a half, currency volatility and potentially higher international oil prices are admittedly a concern.

Chart 2: Treasury cuts inflation forecasts (%)



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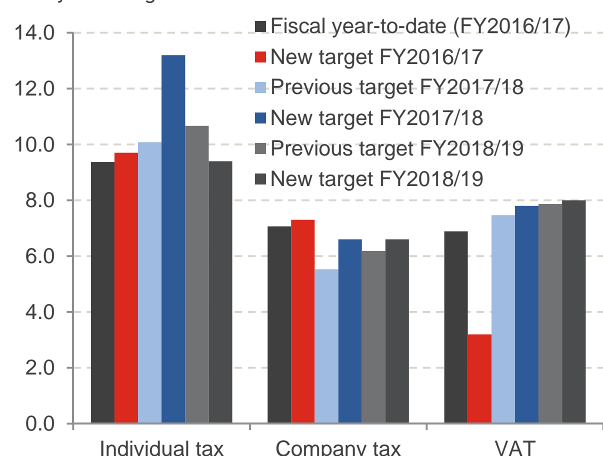
Should nominal GDP underperform relative to Treasury's targets, revenue slippage could lead to a slightly wider-than-expected budget deficit than projected by Treasury. In its February 2017 national budget, Treasury forecasted a narrowing of the budget deficit from 3.4% of GDP in FY2016/17 to 2.6% (2.5% previously) by FY2019/20.

FY17/18 individual tax targets, corporate income tax and value-added tax (VAT) adjusted upwards

On a fiscal year-to-date (YTD) basis, VAT revenues are tracking marginally ahead of Treasury's revised forecasts (see chart 3), while personal taxes and corporate income taxes are trailing the revised target (see chart 3). Although VAT collections are running at a pace of 6.9% year on year (y/y) (fiscal YTD), exceeding Treasury's new target of 3.2%, the sharp downturn in growth in VAT refunds (reflecting delays in the payment of refunds) raises a flag on whether VAT will be able to increase at the same pace in upcoming months. Government's medium-term forecast for VAT to grow at an average rate of 8% per year during the MTEF is, in Momentum Investments' view, achievable.

Chart 3: Tax collection run-rate relative to Treasury's full-year targets



Source: National Treasury, Global Insight, Momentum Investments, new target = set in February 2017

Personal income tax is expected to grow at an average rate of 11% per year during the MTEF, while Treasury expects nominal GDP growth to average 7.9% for the same period. The first year in the MTEF incorporates an adjustment to the uppermost tax bracket, but with households facing continued pressures (including a muted jobs outlook and elevated debt burdens this year), the company thinks there could be some downside risk to these projections.

Corporate income tax is expected to grow at an average rate of 7.1% per year during the MTEF. Delaying the immediate implementation of the carbon tax will likely be a slight positive surprise for corporates, given that the Draft Carbon Tax Bill in November 2015 indicated that companies would be taxed from 2017.However, it was announced that a revised Carbon Tax Bill will be published for public consultation and tabled in Parliament by mid-2017.

A lacklustre growth environment is a risk to government's fiscal consolidation path as it may negatively affect revenue collection. Momentum Investments sees slight downside risks to Treasury's nominal GDP (and hence revenue) forecasts, with trhe company's figures projecting a potential nominal GDP undershoot of around 0.5% on average for the next three years based on a more optimistic view on headline inflation.

A tough economy has seen the share of corporate income tax relative to GDP fall from 6.6% in FY2008/09 to 4.7% in FY2015/16. For the same period, personal income tax as a share of GDP increased from 7.7% to 9.5% and VAT shifted higher from 6.0% to 6.9%. However, despite an unfavourable growth milieu, tax collection has been resilient. The tax revenue buoyancy ratio, which describes the relationship between tax collection and economic growth, has averaged 1.3 since FY2010/11 (and 1.4 in the last three fiscal years), implying that for every 10% growth in nominal GDP, 13% growth in revenue collection could be achieved.

However, with moderate average wage settlements, declining wealth gains, anaemic employment growth, higher taxes, bracket creep, weaker import demand and a firmer rand, there is a risk that tax buoyancy rates could decline by more than Treasury's assumptions, which reach 1.1 by FY2019/20.

Net taxes R28 billion higher in FY2017/18

Government raised the following taxes in the February 2017 national budget:

- Higher personal tax due to only a partial (1%) inflation adjustment to tax brackets (providing R12.1 billion extra)
- A 30c/l hike in the fuel levy (expected to raise R3.2 billion)
- Excise duties on alcohol and tobacco were raised between 6% and 10% (contributes an additional R1.9 billion)
- Dividend withholding tax increased from 15% to 20% (should provide an added R6.8 billion)
- Shifting the top income tax bracket (for individuals earning above R1.5 million per year) from 41% to 45% (amounting to an extra estimated R4.4 billion)
- Sugar tax to be implemented in 2017

Against these tax increases, government provided R0.4 billion relief on transfer duties by raising the threshold. As a result, total net taxes are projected to increase by R28 billion in FY2017/18.

Although hiking the VAT rate could reap meaningful revenue gains further down the line, VAT is deemed to be a regressive tax, falling disproportionately on the poor and middle class, which is exacerbated in a challenging economic climate. Nonetheless, Momentum Investments believes VAT increases in the future, to finance large-scale expenditure programmes such as the National Health Insurance (NHI) plan, are highly likely.

Negative consumer effect

Overall, the budget was negative for the SA consumer. That said, the budget was redistributive in nature, attempting to alleviate the pressure for the lower-income earners, while the higher-income earners bore the brunt of tax increases. Higher-income earners were hit disproportionately, by raising the top income tax bracket to 45% from 41% previously. Additionally, the dividend withholding tax was increased from 15% to 20%.
The negative effect of higher taxes on lower-income earners was, however, partly offset by compensating for bracket creep (raising the tax-free threshold from R75 000 to R75 750), raising the threshold above which transfer duties are paid (from R750 000 to R900 000) in the affordable housing market and ensuring a positive real increase in social grants. On average, social grants are expected to grow at 2.3% per year in real terms during the MTEF.

Although VAT rates were held steady, fuel levies and the Road Accident Fund levy (an additional 9c/l) were hiked, which have a regressive effect on consumers in the economy. Transport services (including bus and taxi fares) constitute an average of 9.8% of the consumption basket belonging to SA's bottom 60% of income earners, whereas the operation of personal transport equipment (including fuel costs) make up an average of only 6.7% of the consumption basket belonging to SA's highest 40% of income earners.

Although government maintains its headcount freeze in the public sector, the total government wage bill is expected to rise at an average rate of 7.2% per year (1.6% per year in real terms) during the MTEF, supporting middle-income earners who are already employed as civil servants.

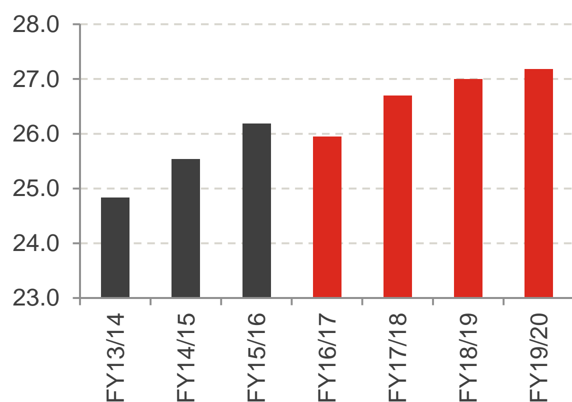
Pace of fiscal consolidation broadly intact

On the consolidated budget figures, total revenue collection is now expected to be R7.4 billion lower for the next three fiscal years (front-end loaded) than projected in the October 2016 MTBPS, while expenditure projections have increased by R5.1 billion for the same time period. As a result, Treasury expects a marginally slower pace of fiscal consolidation than proposed in October last year.

As government attempts to stick to its fiscal consolidation and debt targets in a low-growth environment, SA's tax burden is likely to drift higher. SA's tax-to-GDP ratio is set to climb from 26.2% in FY2015/16 to 27.2% by FY2018/19 (see chart 4) and could rise further in the longer term with the implementation of additional tax measures. The rising tax burden, accompanied by fiscal consolidation, implies that the budget is removing spending power from the

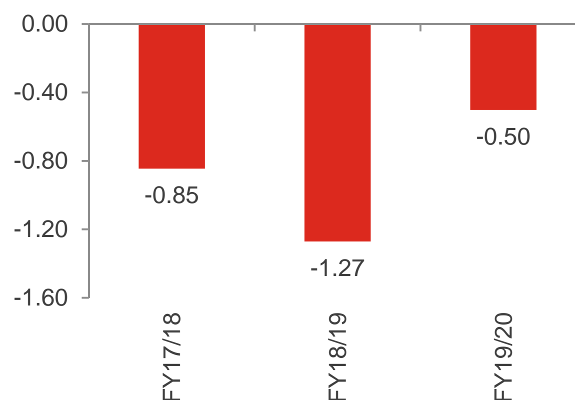
economy on a net basis between FY2016/17 and FY2019/20 and, as such, can be construed as contractionary for SA growth. Furthermore, the fact that spending growth (averaging 7.9% per year in nominal terms between FY2017/18 and FY2019/20) is expected to lag revenue growth (averaging 8.7% per year for the corresponding period) also implies a net drain on economic activity (see chart 5) during the MTEF.

Chart 4: SA's tax to GDP ratio edging higher (%)



Source: National Treasury, Momentum Investments

Chart 5: Revenue outstrips expenditure growth (%)



Source: National Treasury, Momentum Investments

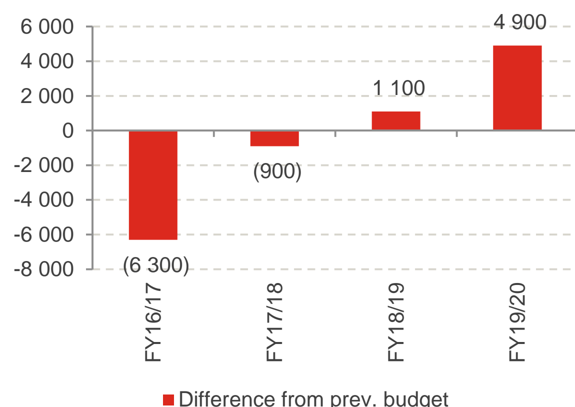
The International Monetary Fund, in its 2010 World Economic Outlook, examined data of the past 30 years to determine the effect of austerity measures on weak-performing economies. It found that fiscal consolidation is typically contractionary.
Fiscal consolidation equating to 1% of GDP typically reduces real GDP by about 0.5% after two years and raises the unemployment rate by 0.3% for the same time frame.

It is crucial that this effect be partly offset by maintaining spend on essential services and preserving social security benefits, including social grants and unemployment insurance fund benefits that protect the more vulnerable income-earning groups. While Treasury has put these measures in place in the short term, for the longer term, a leaner government and deficit reduction are necessary to positively affect the private sector and overall growth.

Keeping to the expenditure ceiling

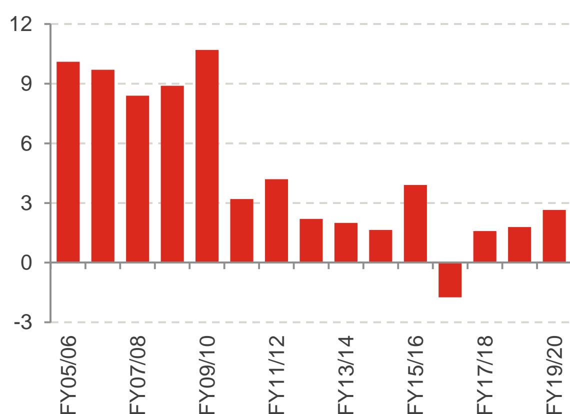
Government has made meaningful cuts to overall expenditure in FY2016/17 and FY2017/18 (see chart 6). Larger cuts have been made to non-interest expenditure, but this measure is still expected to increase by an average of 2% for the next three fiscal years (see chart 7).

Chart 6: Change in expenditure assumptions (R'bn)



Source: National Treasury, Momentum Investments

Chart 7: Total non-interest expenditure (% y/y real)

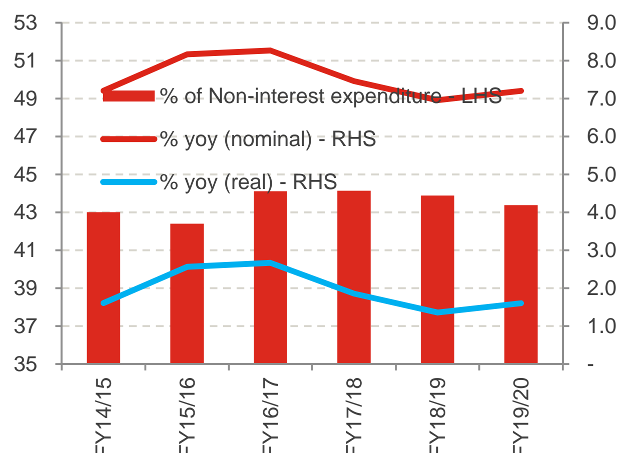


Source: National Treasury, Momentum Investments

Government has furthered its efforts to reduce wasteful and fruitless expenditure. It has implemented a range of efficiency and cost containment measures, including diversifying the number of suppliers and saving on cellular phone, vehicle, information technology and property leasing contracts.

One of the largest expenditure items remains the government wage bill. Total government employee compensation is expected to average 7.2% of non-interest expenditure during the MTEF, averaging 1.6% per year in real terms for the corresponding period (see chart 8). The projected stabilisation in the government wage bill as a share of expenditure remains heavily reliant on measures to reduce appointments to non-critical posts. Government is in the last year of the multi-year wage agreement, but it has assured that negotiations on a new public sector wage agreement are due to begin in 2017. While acknowledging that the wage bill continues to place upward pressure on the expenditure ceiling, Treasury reassured that an agreement has been made that takes account of fiscal constraints and the need to redirect a larger portion of expenditure to capital investment. Even so, a wage agreement that fails to take account of fiscal constraints would undercut progress in containing wage costs and freeing money for other areas of service delivery.

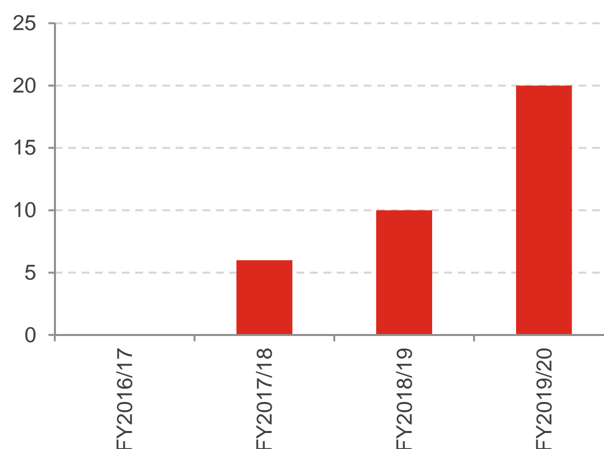
Chart 8: Stabilisation in wage bill at risk



Source: National Treasury, Momentum Investments

The contingency reserve remained unchanged from the levels presented in the October 2016 MTBPS. Maintaining a healthy level of contingency reserves increases SA's fiscal manoeuvrability to deal with unforeseen revenue or expenditure shocks in the coming years. R6 billion has been set aside for FY2017/18, with a larger allocation in the latter years of the MTEF (see chart 9), factoring in a greater degree of uncertainty further into the future.

Chart 9: Contingency reserve unchanged (R'bn)



Source: National Treasury, Momentum Investments

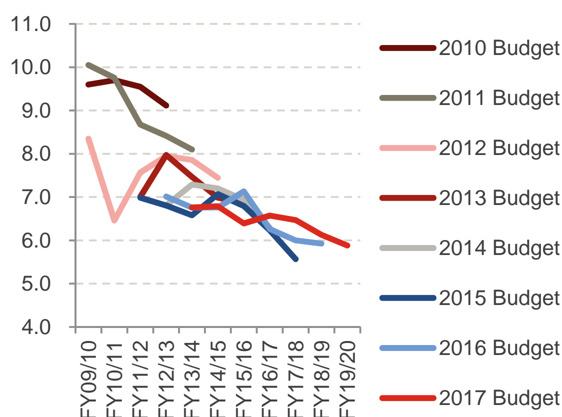
Infrastructure estimates revised higher for the medium term

After consistently surprising to the downside on infrastructure spend relative to previous budget predictions, the trajectory of expected public sector infrastructure relative to GDP turned positive in 2016.

Treasury expects public sector infrastructure to average 6.2% of GDP between FY2017/18 and FY2019/20, slightly higher than the estimates put forward in the February 2016 budget (see chart 10). Treasury expects

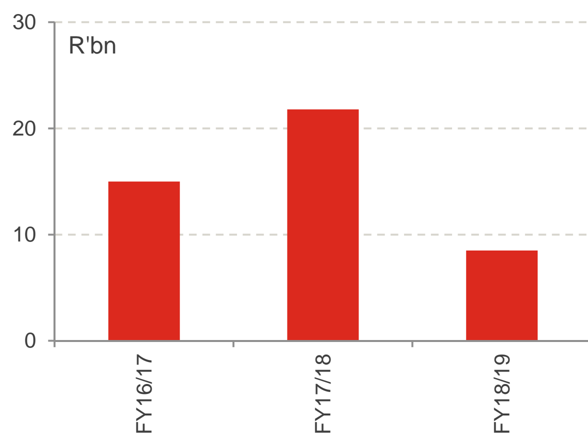
more than R947.1 billion worth in infrastructure spend for the medium term to alleviate bottlenecks, which, in turn, should create a friendlier business environment. Government's revised infrastructure estimates for FY2016/17 to FY2018/19 are R45.3 billion higher than initial projections made in the February 2016 budget (see chart 11).

Chart 10: Public sector infrastructure (share of GDP, %)



Source: National Treasury, Momentum Investments

Chart 11: Upward revisions to infrastructure spend



Source: National Treasury, Momentum Investment

Together, fixed investment spending by state-owned enterprises (SoEs) and government constitutes less than 40% of total fixed investment. Private fixed investment is still the bulk of investment spend in SA, despite dismal growth since the global financial crisis. Growth in private fixed investment growth averaged 0.8% y/y since 2008, declining to a negative rate of 3.9% y/y in the latest six quarters ending in the third quarter of 2016. The trajectory of private fixed investment spend remains concerning against the backdrop of economic policy uncertainty and dull domestic demand clouding the outlook for a further acceleration in infrastructure outlays this year.

The budget revealed little new information regarding the progress made towards gazetting the mining charter and passing the Mineral and Petroleum Resources Development Act (MPRDA) Bill. Moreover, the implementation of the Mining Company of SA Bill during the year is likely to further strain the relationship between government and the mining sector. Without definitive legislation, SA is unlikely to be seen as an attractive destination for new (and foreign) investment in the mining sector.

Similarly, the February 2017 national budget touched on the controversial issue of land reform, by reiterating a point raised in the State of the Nation Address (SONA), that the Department of Human Settlements will draft a Property Practitioners Bill to accelerate efforts of increasing black land ownership. More equitable land ownership could compromise agricultural investment and food security if not approached correctly. Ceilings for private agricultural land ownership and regulating ownership of agricultural land by foreigners could hamper the agricultural sector's development.

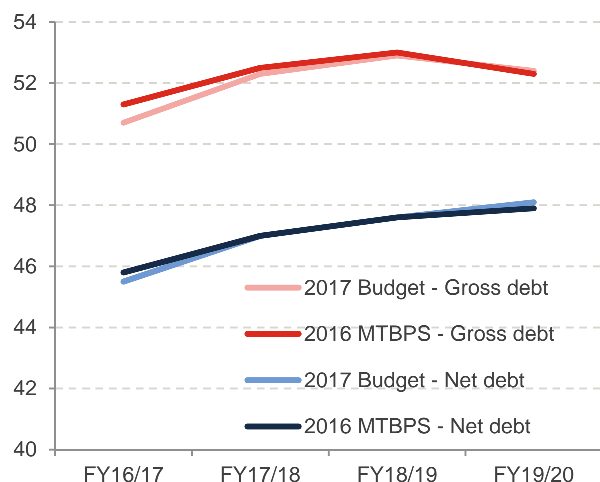
In Momentum Investments' view, transformative efforts driven by increased state intervention could dissuade private fixed investment if not accompanied by new policy initiatives to place the economy on a higher and more sustainable growth path.

Rising debt burden crowding out more desirable forms of expenditure

Government acknowledges that a key risk to its borrowing programme is the re-pricing of government debt at a higher level. Treasury explained that revenue shortfalls and the build-up of cash reserves for large debt redemptions for the period ahead have resulted in higher debt levels. The gross debt-to-GDP ratio is expected to peak at 52.9% of GDP by FY2018/19 (0.1% lower than projected in the October 2016 MTBPS), while the peak in the net debt-to-GDP ratio deteriorated by 0.2% to 48.1% in the outer fiscal year of the MTEF relative to the MTBPS in

October 2016 (see chart 12). Net debt is now forecast to stabilise at 48.2% of GDP in FY2020/21.

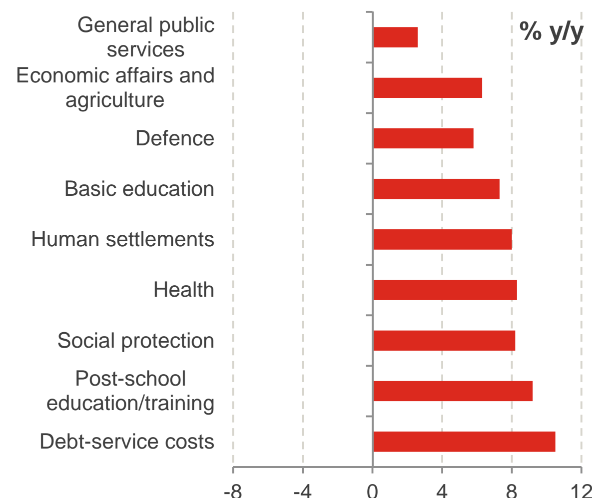
Chart 12: Stabilisation in gross debt (% of GDP)



Source: National Treasury, Momentum Investments

In October 2016, government announced that it will fund the increase in tertiary fees (up to 8%) for the 2017 academic year. This includes a R9.2 billion allocation to the National Student Financial Aid Scheme, R7.8 billion in support for students from households earning less than R600 000 per year and additional money (R0.5 billion) for technical and vocational education and training colleges. Treasury had also previously noted, in its fiscal risk statement in October 2016, that a 0% university fee increase in 2018 would likely result in a shift of resources from other priorities towards higher education. In the February 2017 national budget, government announced that an additional R5 billion will be provided for higher education in the outer year of the MTEF. Post-school education and training expenditure is expected to grow at an average of 9.2% y/y during the next three fiscal years (see chart 13).

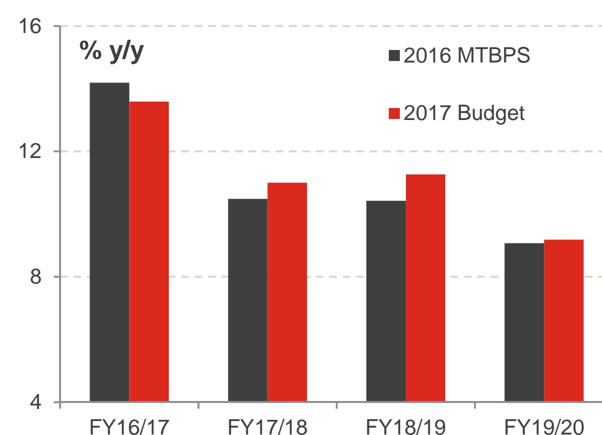
Chart 13: Average growth in expenditure during MTEF



Source: National Treasury, Momentum Investments

The only expenditure item that grows at a faster pace during the MTEF is debt-servicing costs. Debt-servicing costs are expected to increase at an average rate of 10.5% y/y per year (4.6% in real terms) for the medium term (see chart 14). The rapid rise in debt-servicing costs is crowding out other (social and growth-enhancing) spending priorities and has been raised as a key concern by the rating agencies in the past.

Chart 14: Higher growth in debt-servicing costs



Source: National Treasury, Momentum Investments

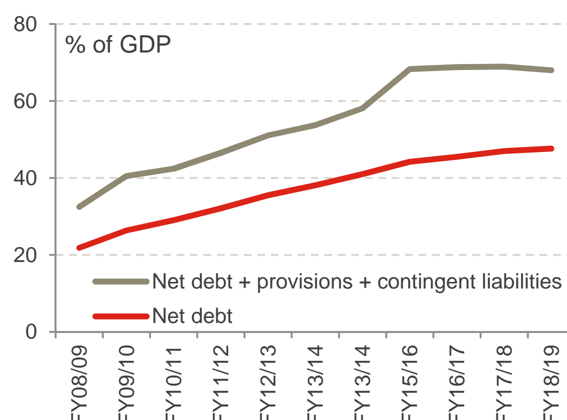
SoE efficiency and governance not adequately addressed

Given that the SONA failed to address SoE reforms, ratings agencies were likely watching the budget for any progress made on improving the financial standing of these institutions and enhancing governance measures. Treasury suggested that the recommendations of the Presidential Review Committee on SoEs are being implemented. These include the rationalisation of a number of entities and using equity and expertise from the private sector to strengthen managerial and financial capacity. Treasury aims to address the risk of poorly

performing SoEs by tabling a quarterly report in Parliament, providing updates on guarantees extended, the extent of exposure against guarantees and the data on the portfolio of SoE assets.

Net debt, provisions and contingent liabilities as a share of GDP is set to peak at 68.9% in FY2017/18 and decrease marginally during the remainder of the MTEF (see chart 15). This is marginally higher than the 68.8% peak assumed in the October 2016 MTBPS.

Chart 15: Total debt (share of GDP, %)



Source: National Treasury, Momentum Investment

High financing needs for longer-term spending projects

The high funding requirements associated with longer-term projects (for example nuclear) or structural increases in expenditure (for example NHI) are increasingly demanding in a low-growth environment. In 2015, a R200 million provision was made to support preparatory work for nuclear procurement. While the February 2017 national budget and SONA were quiet on the nuclear matter, the project remains shrouded in uncertainty. Despite the 2016 Integrated Resource Plan confirming that nuclear power would not be required in the next two decades, Eskom was appointed as a nuclear procurer in December 2016, raising concerns over Treasury's ability to curb the increase in contingent liabilities. Since, it has been reported that at least 27 companies have so far notified Eskom of their interest in participating in the first stage of the new nuclear build programme.

Treasury announced that government is moving towards the next phase of the implementation of the NHI after achieving a better design of contracts with general practitioners, more effective chronic medicine dispensing, supportive information systems and strengthening services by building capacity. Funding options are being explored (including possible adjustments to the tax credit on medical scheme contributions) and more details will be given in October 2017.

The NHI White Paper predicts that the baseline public health budget would ramp up from R134 billion in FY2015/16 to R256 billion by FY2025/26 (based on 2010 prices), equating to growth of 6.7% per year in real terms. The four revenue proposals outlined (including an increase in VAT), however, are based off a higher trend growth rate of 3.5%, suggesting that higher financing needs are likely to be associated with this longer-term venture.

Fiscal prudence good for ratings, but subdued growth, political challenges and slow reform progress remains problematic

In Momentum Investments' view, downtrodden business confidence hinders SA's longer-term growth prospects, leaving the economy trapped in a low-growth environment. In the absence of growth-enhancing economic reforms and policy certainty, SA will struggle to return to its historical trend growth rate of 3.1%, leaving revenue collection under pressure in the medium term. Low growth could further result in a rise in political and socio-economic tensions further down the line.

A weak growth trajectory is likely to leave SA's fiscal and debt metrics susceptible to adverse shocks, which could reduce the country's overall creditworthiness. While one of the historical cornerstones of SA's investment-grade rating has been its highly regarded institutional framework, Nenegate in December 2015 and growing speculation of an unnecessary Cabinet reshuffle have introduced worries that key institutions are no longer

deemed untouchable by politicians and could be less independent than previously perceived.

Unfavourable economic conditions and the absence of bolder reform efforts could lead Moody's to contemplate a ratings downgrade of SA's sovereign debt to the lowest investment grade level, while the country remains vulnerable to a ratings downgrade to sub-investment grade by S&P later this year (see table 1).

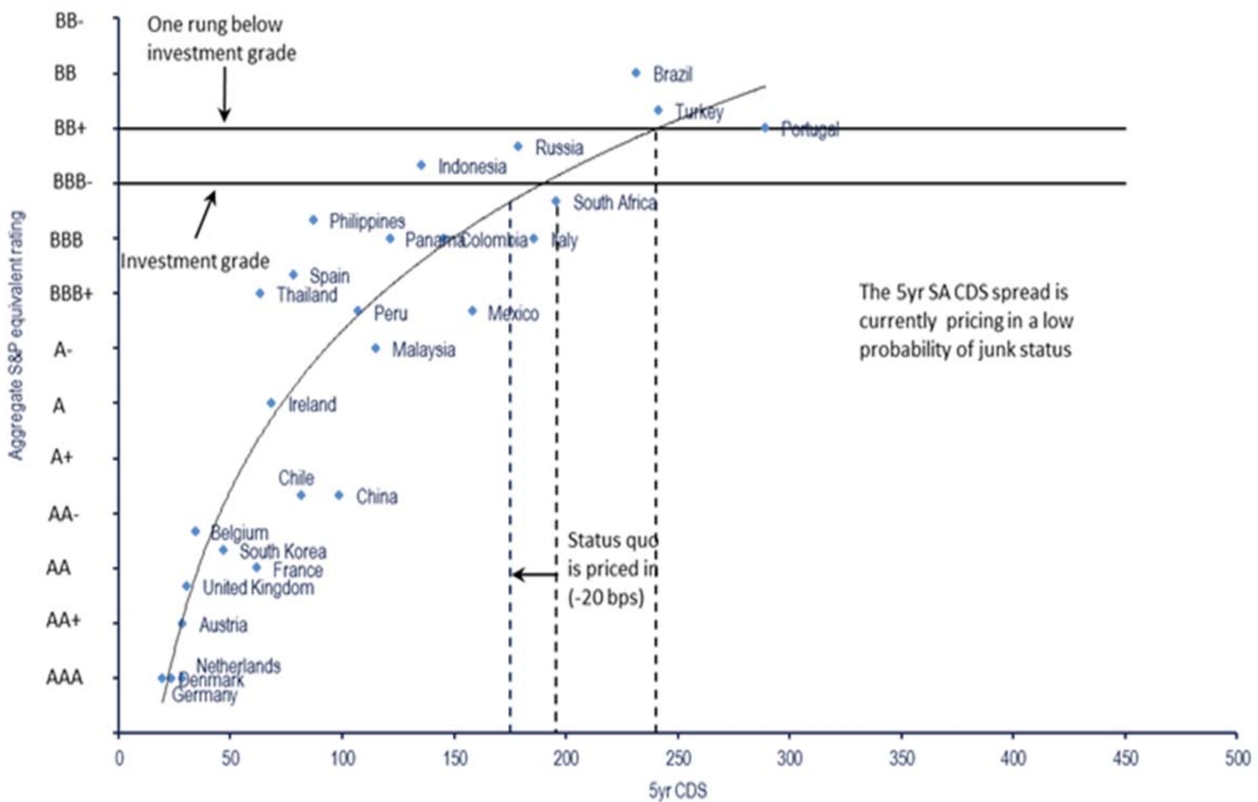
Table 1: SA's sovereign ratings

	S&P	Fitch	Moody's
Investment grade	A3	A3	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1

Source: S&P, Moody's, Fitch, pink = foreign currency rating, blue = local currency rating

Meanwhile, the five-year credit default swap spread (a measure gauging country risk) has narrowed considerably to 200 basis points from 250 basis points following Nenegate. Chart 16 suggests that at these levels the market views SA's credit rating as broadly appropriate. If the spread is sustained at these levels, the relationship between credit default swap spreads and sovereign ratings suggests that a downgrade by the end of the year could cause a knee-jerk reaction in financial markets.

Chart 16: Market not discounting junk status at this point



Source: Investec

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